



## 2017 Tax Reform – Common Items Affecting Investment Partnership Funds and Their Fund Managers

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The below is a compilation of some of the more common questions asked by fund managers regarding tax reform and how it affects their funds, investors, management companies, and individual tax returns. Please note that this is not an all-inclusive list of tax reform items affecting the aforementioned groups. For tax planning and questions, please consult a Richey May professional or your tax advisor.

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### Carried Interest

**Updated Law:** The new law adds Code Section 1061, which changes the holding period requirement for long-term capital gain treatment on the sale of underlying assets related to “applicable partnership interests.” “Applicable partnership interests” are generally partnership interests that receive certain performance allocations from a partnership related to services performed for such partnership, often referred to as carried interest. The new holding period changes the “greater than one year” requirement for long-term capital gain treatment to a “greater than three years” requirement.

The new holding period rule does have two important exemptions that exclude certain partnership interests from being treated as “applicable partnership interest.” First, an applicable partnership interest does not include a capital interest related to contributed capital. Second, an applicable partnership interest does not include a partnership interest held by a corporation. However, there is a lack of clarity on the scope of each of these exemptions. For contributed capital, it is unclear if previously crystallized carried interest that is reinvested or not withdrawn from the partnership is considered contributed capital for the exemption. Additionally, for the scope of the term “corporation,” it is unclear if an S corporation would be included in the exemption, though based on the intent of the rule change, it seems that an S corporation would likely not be included as a “corporation” for these purposes.

**Fund/Fund Manager Effect:** The new law typically will affect the general partner in the fund receiving carried interest or the incentive/performance allocations. This change will also generally apply to transferred carried interests, though some transfers of carried interests to related parties may cause a taxable event related to such transfer. It is important to note that although this rule may cause a higher tax rate on certain types of income for the general partner or applicable partnership interest holder, the rule will not change the tax character for limited partners.

**Moving Forward:** Although the exact method of reporting is currently unknown, we anticipate an additional tracking system for accounts related to those receiving carried interest, including potentially bifurcating portions of general partner interests that are exempt from the rule. Since the holding period requirements for the limited partners and general partners are different, tracking these accounts separately will be needed in order to provide correct tax treatment on partnership gains to the investors. As more clarity to these rules come forward, additional planning opportunities may arise.

## Other Miscellaneous Deductions (2% Floor)

**Updated Law:** The new law suspends the deduction for individuals of miscellaneous itemized deductions subject to the 2% AGI limitation. This suspension is for tax years beginning after December 31, 2017 and before January 1, 2026.

**Fund/Fund Manager Effect:** All “investor” fund portfolio deductions are now non-deductible to individual partners of the fund. Included in this bucket are service provider expenses, management fees payable to the fund manager, and other various entity level expenses. At the individual level, examples of other expenses that have been allowed in the past, but which are no longer allowed, are tax preparation fees, estate planning fees, and non-reimbursed employee expenses. It is important to note that the investment interest expense deduction was not changed and will still be available based on existing investment interest expense limitations.

**Moving Forward:** As a result of these changes, there may be added incentive to reduce management fees at the fund level and increase the amount of incentive allocation the managing member receives. In addition, there may be opportunities to set up passive foreign investment company (PFIC) structures to maximize the usability of other portfolio deductions. Each fund has different facts and circumstances and the usefulness of such structures should be evaluated on a case-by-case basis.

## State and Local Tax Deduction

**Updated Law:** The new law limits annual itemized deductions for all non-business state and local taxes, which include property taxes, up to \$10,000. The \$10,000 limit is reduced to \$5,000 for married taxpayers filing a separate return. Foreign real property taxes may not be deducted under the new law.

**Fund/Fund Manager Effect:** Funds will continue to deduct state and local taxes at the partnership level and flow through to the investors. There is no specific limit on the deductibility of these amounts except for limitations related to the character of the pass-through expense, such as miscellaneous portfolio deductions discussed above. Fund managers with higher personal state and local taxes may lose the deductibility of a portion of those state and local taxes.

**Moving Forward:** State and local taxes at the fund level will still be treatable as an investment expense that reduces fund taxable income.

## Pass-through Income Deduction

**Updated Law:** A new deduction is available on “qualified business income” of pass-through entities that are non-service in nature. This deduction is up to 20% of such income, but may be subject to specified business asset and wage limitations.

**Fund/Fund Manager Effect:** The “qualified business income” definition does not include investment income typically seen at funds and generally does not include income from services performed, including investment management services, by the fund manager. As such, this deduction is generally not applicable to funds as structured. However, in some limited instances, smaller fund managers who meet certain individual income thresholds (taxpayer taxable income under \$315,000 for married filing jointly or \$157,500 for single with a phase-out for income above the threshold) may be able to utilize an exception at the management company that allows non-qualified business income to be considered for a deduction. Fund managers should consult with their tax advisors for such applicability.

**Moving Forward:** The strategy of investment and trading funds currently precludes investors in most cases from benefitting from this new tax law. Certain fund managers who meet individual income thresholds may be able to benefit from this deduction.

## Sale of Partnership Interests

**Updated Law:** Gain or loss on sale of a partnership interest would trigger Income Effectively Connected to a U.S. Trade or Business (“ECI”) characterization to the extent that the seller would have ECI if the partnership liquidated as of the sell date.

**Fund/Fund Manager Effect:** In the event of the sale of an interest in an ECI producing partnership, including U.S. based private operating partnerships, publicly traded partnerships and master limited partnerships, ECI income would be triggered and amounts allocated to the foreign investors would be subject to withholding by the fund. Additionally, the fund foreign investors may have a U.S. tax filing obligation related to the receipt of ECI.

**Moving Forward:** Foreign structured funds or funds with foreign investors should take careful consideration of investment strategy and investor goals. Increased ECI may deter foreign-based investors from investing into U.S. based funds without adequate blocking structures.

## Unrelated Business Taxable Income Reporting

**Updated Law:** Unrelated Business Taxable Income (UBTI) losses are now offset against UBTI gains from the same trade or business that produces such UBTI.

**Fund/Fund Manager Effect:** UBTI is now calculated on a standalone basis by activity and losses in excess of gains are disallowed. Any excess losses would be carried forward against potential UBTI gains from the same activity.

**Moving Forward:** With limited UBTI losses, there is a strong likelihood of seeing less UBTI loss flowed through to the fund from underlying partnerships, and less overall UBTI loss flowing to the members of each fund.

## Management Company Conversion to a C-Corporation

**Updated Law:** The new law imposes a flat corporate tax rate of 21%, eliminating the prior progressive corporate rate with the top rate of 35%. The new law also eliminates the corporate alternative minimum tax.

**Fund/Fund Manager Effect:** Some fund managers may consider converting to a C corporation to take advantage of the new lower corporate tax rate. This option may also merit consideration since investment management income doesn’t qualify as “qualified business income” for the pass-through deduction. However, careful considerations should be given to converting because C corporations still have double taxation, are inflexible compared to partnerships for income/loss allocations, and have distribution requirements for certain types of income and investment income that reduces the potential for deferral of the dividend related tax.

## Active Business Loss Limitation

**Updated Law:** Prior law limited passive losses to be allowable to the extent of passive income. Beginning in 2018, the new tax law limits excess active business losses (defined as > \$499,999 for married taxpayers filing jointly and > \$249,999 for single taxpayers). These losses will be disallowed in the current year and carried forward to be deducted in future years. Taxpayers will be allowed losses up to \$500,000 and \$250,000 respectively for married taxpayers filing jointly and single taxpayers.

**Fund/Fund Manager Effect:** This could affect investment managers who have large losses at the management company, and who have historically been able to offset those losses against investment income from their fund.

**Moving Forward:** Fund managers who may have this apply could consider options such as increasing management fees and decreasing bonuses and wages and replacing them with carried interest sharing.

## Personal Exemption and Standard Deduction

**Updated Law:** The personal exemption has been eliminated and the standard deduction has been increased. Below are the amounts of the personal exemption in effect for 2017 and that will be in effect for 2018.

**2017 - \$4,050**

**2018 - \$0**

The personal exemption is subject to a phase-out in 2017 that begins with adjusted gross incomes of \$261,500 for single taxpayers and \$313,800 for married taxpayers filing jointly. The elimination of the personal exemption will have a larger impact on taxpayers with lower adjusted gross incomes since taxpayers with adjusted gross incomes at or above the amounts mentioned above will not get the benefit of the personal exemption on their return in 2017.

To offset the loss of the personal exemption and to encourage less itemized deductions, the new tax law increases the standard deduction. The chart below shows the standard deduction amount for 2017 and what the increased amount will be for 2018.

| Filing Status            | 2017     | 2018     |
|--------------------------|----------|----------|
| Single                   | \$6,350  | \$12,000 |
| Head of household        | \$9,350  | \$18,000 |
| Married, filing joint    | \$12,700 | \$24,000 |
| Married, filing separate | \$6,350  | \$12,000 |

## New Tax Rates

**Updated Law:** New tax rates and brackets are also in effect beginning in 2018. Below is a table that shows what the rates would be in 2018 under the current law compared to what the rates will be under the new law for both married filing joint and single taxpayers.

### Married, filing joint

| 2018 Current Law |                       | New Law  |                       |
|------------------|-----------------------|----------|-----------------------|
| Tax Rate         | If taxable income is: | Tax Rate | If taxable income is: |
| 10%              | \$0 - \$19,050        | 10%      | \$0 - \$19,050        |
| 15%              | \$19,051 - \$77,400   | 12%      | \$19,051 - \$77,400   |
| 25%              | \$77,401 - \$156,150  | 22%      | \$77,401 - \$165,000  |
| 28%              | \$156,151 - \$237,950 | 24%      | \$165,001 - \$315,000 |
| 33%              | \$237,951 - \$424,950 | 32%      | \$315,001 - \$400,000 |
| 35%              | \$424,951 - \$480,050 | 35%      | \$400,001 - \$600,000 |
| 39.6%            | \$480,051 – or more   | 37%      | \$600,001 – or more   |

### Single

| 2018 Current Law |                       | New Law  |                       |
|------------------|-----------------------|----------|-----------------------|
| Tax Rate         | If taxable income is: | Tax Rate | If taxable income is: |
| 10%              | \$0 - \$9,525         | 10%      | \$0 - \$9,525         |
| 15%              | \$9,526 - \$38,700    | 12%      | \$9,526 - \$38,700    |
| 25%              | \$38,701 - \$93,700   | 22%      | \$38,701 - \$82,500   |
| 28%              | \$93,701 - \$195,450  | 24%      | \$82,501 - \$157,500  |
| 33%              | \$195,451 - \$424,950 | 32%      | \$157,501 - \$200,000 |
| 35%              | \$424,951 - \$426,700 | 35%      | \$200,001 - \$500,000 |
| 39.6%            | \$426,701 – or more   | 37%      | \$500,001 – or more   |

## Individual Alternative Minimum Tax

**Updated Law:** Alternative minimum tax (AMT) for individuals is retained under the new law, but with modifications so it will be applicable to fewer taxpayers than in the past. Below is a summary of the impact to both married taxpayers filing jointly and single taxpayers.

|                                      | 2017      | 2018        |
|--------------------------------------|-----------|-------------|
| Exemption for married filing jointly | \$84,500  | \$109,400   |
| Phase out of exemption begins at     | \$160,900 | \$1,000,000 |
| Exemption for single                 | \$54,300  | \$70,300    |
| Phase out of exemption begins at     | \$120,700 | \$500,000   |

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